The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 16786

November 21, 2003

MUTUAL FUND LEGISLATION APPROVED BY U.S. HOUSE OF REPRESENTATIVES

[16786] November 21, 2003 TO: ACCOUNTING/TREASURERS MEMBERS No. 47-03 BOARD OF GOVERNORS No. 65-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 96-03 FEDERAL LEGISLATION MEMBERS No. 25-03 INVESTMENT COMPANY DIRECTORS No. 20-03 OPERATIONS MEMBERS No. 35-03 PENSION MEMBERS No. 48-03 PRIMARY CONTACTS - MEMBER COMPLEX No. 103-03 PUBLIC INFORMATION COMMITTEE No. 41-03 SEC RULES MEMBERS No. 162-03 SMALL FUNDS MEMBERS No. 69-03 UNIT INVESTMENT TRUST MEMBERS No. 44-03 RE: MUTUAL FUND LEGISLATION APPROVED BY U.S. HOUSE OF REPRESENTATIVES On November 19, 2003, the U.S. House of Representatives approved H.R. 2420, the “Mutual Funds Integrity and Fee Transparency Act of 2003” (“Act”), by a 418-2 vote.1 During floor consideration, the bill was amended to add several provisions intended to address abusive mutual fund trading practices.2 Mutual fund legislation also has been introduced in the Senate, but no final Senate action is expected this year.3 Senate consideration of mutual fund legislation likely will resume when the Senate reconvenes in late January. The House bill is summarized below. 1 A copy of the bill as approved by the House is available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:h2420eh.txt.pdf. 2 These provisions are in Title II of the bill. Title I of the bill is almost identical to the version of H.R. 2420 approved by the House Financial Services Committee on July 23, 2003. A provision relating to investment company and investment adviser compliance programs was deleted from Title I because a revised version of that provision is included in Title II. 3 S.1822, the “Mutual Fund Transparency Act of 2003,” was introduced earlier this month by Senator Daniel K. Akaka (D-HI), the Ranking Member of the Financial Management Subcommittee of the Senate Committee on Governmental Affairs. It is co-sponsored by Senator Peter G. Fitzgerald (R-IL), Chairman of the Financial Management Subcommittee, and Senator Joseph I. Lieberman (D-CT), the Ranking Member of the full Committee on Governmental Affairs. A copy of S.1822 is available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:s1822is.txt.pdf. In addition, Senators Jon Corzine (D-NJ) and Christopher Dodd (R-MO), members of the Senate Banking Committee, have announced their intention to propose 2 TITLE I – INTEGRITY AND FEE TRANSPARENCY Improved Transparency of Mutual Fund Costs The bill would direct the SEC, within 270 days after the date of enactment of the Act, to adopt rules to require an open-end management investment company to disclose the following: • the estimated amount, in dollars for each $1,000 of investment in the company, of the operating expenses of the company that are borne by shareholders; • the structure of, or method used to determine, the compensation of individuals employed by the fund’s investment adviser to manage the fund’s portfolio and the ownership interests of such persons in the fund’s securities; • the portfolio turnover rate of the company, set forth in a manner that facilitates comparison among investment

companies, and a description of the implications of a high turnover rate for portfolio transaction costs and performance; • information concerning soft dollar and directed brokerage policies and practices; • information concerning revenue sharing payments; and • information concerning breakpoint discounts on front-end sales loads. The foregoing disclosures would be required in the quarterly statement or other periodic report to shareholders or other appropriate disclosure document, but could not be made exclusively in a prospectus or statement of additional information. The bill provides an exception from this requirement for the disclosures concerning (1) portfolio manager compensation and holdings and (2) soft dollar and directed brokerage policies and practices. The bill would require the SEC to issue a concept release to examine the issue of portfolio transaction costs and how such costs may be disclosed to investors in a manner that will enable them to compare such costs among funds. The SEC would be required to report its findings to Congress no later than 270 days after enactment of the Act. In addition, the SEC would be required to adopt, within 270 days of enactment, a rule requiring that periodic account statements contain a statement informing shareholders that they have paid fees on their investments, that such fees have been deducted from the amounts shown on the statements, and where shareholders may find additional information regarding the amount of these fees. In prescribing rules to implement the above requirements, the SEC would be required to give consideration to methods for reducing the burdens to small investment companies of making this disclosure, consistent with the public interest and the protection of investors. mutual fund legislation. Although they have not yet provided legislative language, a summary of their proposal is available at http://corzine.senate.gov/clippings/onepagesummary.corzine.dodd.pdf. 3 Obligations Regarding Certain Distribution and Soft Dollar Arrangements The bill would amend Section 15 of the Investment Company Act to require each adviser to a registered investment company to annually provide the fund’s board of directors with a report on (1) revenue sharing arrangements, (2) directed brokerage arrangements, and (3) soft dollar arrangements. It would impose a fiduciary responsibility on fund directors to review these arrangements and to determine that the direction of fund brokerage is in the best interests of fund shareholders and that revenue sharing arrangements are consistent with the Investment Company Act and in the best interests of fund shareholders. The SEC would be given rulemaking authority to implement these requirements. The implementing regulations would have to require that annual reports to shareholders contain a summary of the reports submitted to fund directors under this provision. The SEC also would be required to adopt a rule within 270 days of the Act’s enactment requiring that if research services are provided by a member of an exchange, broker, or dealer who effects securities transactions in an account and are prepared or provided by a party that is unaffiliated with such exchange member, broker, or dealer, any person exercising investment discretion with respect to the account must maintain a copy of the written contract between the exchange member, broker, or dealer and the person preparing the research, and the contract must describe the nature and value of the services provided. Mutual Fund Governance The bill would amend Section 10(a) of the Investment Company Act to require two- thirds of a fund’s board to be independent. In addition, it would amend the definition of “interested person” in Section 2(a)(19) of the Investment Company Act to include any person who is a member of a class of persons who the SEC, by rule, determines are unlikely to exercise an appropriate degree of independence as a result of (1) a material business relationship with the fund, its investment adviser or principal underwriter or any of their affiliated persons, or (2) a close familial relationship with any natural person who is an affiliated person of the fund, its investment adviser or principal underwriter or their affiliated persons. Audit Committee Requirement The bill would apply to open-end investment companies audit committee standards similar to those imposed on listed

companies by Section 301 of the Sarbanes-Oxley Act of 2002 and Rule 10A-3 under the Securities Exchange Act of 1934. Trading Restrictions The bill would amend Section 22(e) of the Investment Company Act, which currently prohibits a registered investment company from suspending redemptions of fund shares for more than seven days after they are tendered for redemption except, among other circumstances, for any period during which the New York Stock Exchange is closed other than customary week-end and holiday closings or during which trading on the NYSE is restricted. Under the amendment, a fund could suspend redemptions "for any period during which the principal market for the securities in which the [fund] invests is closed or trading restricted, other than customary week-end and holiday closings." The SEC would have rulemaking 4 authority to provide for the determination by each fund, subject to limitations established by the SEC, the principal market for the securities in which the fund invests. Definition of No-Load Mutual Fund The bill would require the adoption of SEC or self-regulatory organization rules to (1) clarify the definition of "no-load" as used by funds that have 12b-1 fees and (2) require disclosure to prevent investors from being misled by the use of this term by the fund or its adviser or principal underwriter. Informing Directors of Significant Deficiencies The bill would require that if a report of an SEC inspection of a fund identifies significant deficiencies, the fund must provide that report to its directors. Exemption from In-Person Meeting Requirement The bill would amend Section 15(c) of the Investment Company Act to authorize the SEC to exempt a fund from the in-person meeting requirement, "when such a requirement is impracticable, subject to such conditions as the [SEC] may require." Proxy Voting Disclosure The bill would make the disclosure by mutual funds of their proxy votes a statutory requirement. Incentive Compensation and Mutual Fund Sales The bill would require the SEC to adopt rules requiring disclosure concerning incentive and other compensation paid to broker-dealers for selling mutual funds. SEC Study and Report on Soft Dollar Arrangements The bill would call for an SEC study of the use of soft dollar arrangements by investment advisers. The SEC would be required to report to Congress on this study no later than one year after enactment of the Act. Study of Arbitration Claims The bill would require the SEC to conduct a study of the increased rate of arbitration claims and decisions involving mutual funds since 1995, for the purpose of identifying trends in claim rates and, if applicable, the causes of such increased rates and the means to avert such causes. The SEC would be required to submit a report to Congress on the study no later than one year after enactment of the Act. 5 TITLE II – PREVENTION OF ABUSIVE MUTUAL FUND PRACTICES Prevention of Fraud; Internal Compliance and Control Procedures The bill would amend Section 17(j) of the Investment Company Act by expanding it to cover fraudulent, deceptive or manipulative acts, practices, or courses of business in connection with purchases or sales by certain persons, not only of any security held or to be acquired by a registered investment company (as is currently the case), but also of any security issued by the investment company or an affiliate. The SEC would have to adopt rules (1) requiring registered investment companies and their investment advisers and principal underwriters to adopt codes of ethics and (2) requiring registered investment companies to disclose their codes of ethics, and any changes therein, in the periodic report to shareholders and to disclose such codes and any waivers and material violations thereof on a readily accessible electronic public information facility of the fund and in such other form and manner as the SEC shall require. In addition, registered investment companies and registered investment advisers would be required to adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws and certain other designated laws, and to review the policies and procedures annually for their adequacy and the effectiveness of their implementation. Investment companies would be required to appoint a chief compliance officer to oversee the policies and procedures. The chief compliance officer, whose compensation would have to be approved by a fund's

independent directors, would be required to report directly to the independent directors at least annually, in private if the directors so request. These reports would have to include any violations or waivers of, or other significant issues arising under, the compliance policies and procedures. Funds also would be required to adopt policies and procedures reasonably designed to protect their officers, directors, employees, contractors, subcontractors, or agents from retaliation for providing information to assist in an investigation relating to conduct that the person reasonably believes constitutes a violation of either the securities laws or a fund's code of ethics. Finally, the independent directors of registered open-end investment companies would be required to certify that: (1) procedures are in place for verifying that the determination of the fund's current NAV complies with the Investment Company Act and rules thereunder, and that the fund is in compliance with such procedures; (2) procedures are in place for the oversight of the flow of funds into and out of the fund and the fund is in compliance with those procedures; (3) procedures are in place to ensure that investors are receiving any applicable sales charge breakpoint discounts; (4) procedures are in place to ensure that, if the fund has multiple classes, they are designed in the interests of investors and could reasonably be an appropriate investment option for an investor; (5) procedures are in place to ensure that information about the fund's portfolio securities is not disclosed in violation of the securities laws or the fund's code of ethics; (6) the independent directors have reviewed and approved the compensation of the fund's portfolio manager; (7) the fund has established and enforces a code of ethics in accordance with the requirements noted above; and (8) the fund is in compliance with the bill's provisions relating to adoption and implementation of compliance policies and procedures. 6 The bill would require the SEC to prescribe rules implementing all of the foregoing requirements within 90 days after the date of enactment of the Act. Ban on Joint Management of Mutual Funds and Hedge Funds The bill would amend Section 15 of the Investment Company Act to prohibit an individual from serving as the portfolio manager or investment adviser of both a registered mutual fund and an unregistered investment company or other category of company prescribed by SEC rule in order to prevent conflicts of interest. The SEC would have to prescribe implementing rules within 90 days after the date of enactment of the Act. The SEC would be permitted to make exceptions to the joint management prohibition when necessary to protect the interest of investors, but any rule, regulation or order doing so would have to require (1) enhanced disclosure by the mutual fund to investors of any conflicts of interest raised by the joint arrangement and (2) fair and equitable policies and procedures for allocating securities to the portfolios of the jointly managed companies, as well as certification by the mutual fund's independent directors in the periodic report to shareholders or other appropriate document that such policies and procedures are fair and equitable. Short Term Trading by Interested Persons Prohibited The bill would prohibit certain persons4 from engaging in "short-term transactions" (to be defined by SEC rule) in securities issued by a registered investment company or its affiliate, other than money market funds, other funds whose investment policy expressly permits short- term transactions, or other categories of registered investment companies specified by SEC rule. The SEC would be required to prescribe implementing rules within 90 days after the date of enactment of the Act. Within the same time period, the SEC also would be required to revise its rules as necessary to permit an investment company to charge redemption fees in excess of 2 percent upon the redemption of the company's securities within such period after their purchase as the SEC specifies to prevent short term trading that is unfair to the investment company's shareholders. Elimination of Stale Prices Within 90 days after the date of enactment of the Act, the SEC would be required to prescribe standards concerning the obligations of registered open-end investment companies to apply and use fair value methods of net asset value (NAV) determination in order to prevent dilution of the interests of long-term

investors or as necessary in the other interests of investors. The SEC would have to identify, in addition to significant events, the conditions or circumstances from which the obligation to use fair value will arise and the methods by which fair value methods shall be applied. 4 These persons are any officer, director, partner, or employee of a registered investment company, any affiliated person, investment adviser, or principal underwriter of such company, or any officer, director, partner, or employee of such an affiliated person, investment adviser, or principal underwriter. 7 Prevention of Unfair After-Hours Trading Within 90 days after the date of enactment of the Act, the SEC would be required to issue rules to prevent transactions in the securities of any registered open-end investment company in violation of Section 22 of the Investment Company Act, including after-hours trades that are executed at a price based on an NAV that was determined as of a time prior to the actual execution of the transaction. The rules would have to permit execution of such "after- hours trades" that are provided to a mutual fund by an intermediary after the time as of which such NAV was determined if the intermediary has procedures that are (1) designed to prevent the acceptance of trades by the intermediary after the time as of which NAV was determined and (2) subject to an independent annual audit to verify that the procedures do not permit the acceptance of trades after the time as of which such NAV was determined. In addition, the rules would have to permit firms that collect transactions via computer systems and procedures provided by unaffiliated entities to satisfy the foregoing independent audit requirement by means of an independent audit obtained by the unaffiliated entity. Report on Adequacy of Remedial Actions Within 180 days of the date of enactment of the Act, the SEC would be required to submit a report to Congress on market timing and late trading of mutual funds, which would have to include: (1) the economic harm of market timing and late trading of mutual funds on long-term shareholders; (2) the findings of the SEC's Office of Compliance Inspections and Examinations and the actions taken by the Division of Enforcement regarding illegal late trading practices, illegal market timing practices, and market timing practices that are not in violation of prospectus disclosures; (3) when the SEC became aware that the use of market timing practices was harming long-term shareholders and the circumstances surrounding the SEC's discovery of that activity; (4) the steps the SEC has taken to protect long-term fund investors since that time; and (5) any additional legislative or regulatory action that is necessary to protect long-term mutual fund shareholders against the detrimental effects of late trading and market timing practices. We will keep you informed of further developments. Matthew P. Fink President

---